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In the Supreme Court of the United States

October Term, 1960

RAYMOND L. DOTY, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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QUESTIONS PRESENTED

1. Whether the traditional prohibition against defrauding investors by trading on inside information, recognized by this Court in *Chiarella* v. *United States*, 445 U.S. 222 (1980), is ousted when the inside information relates to criminal conduct.

2. Whether substantial evidence in the record supports the finding of the Securities and Exchange Commission, affirmed by the court of appeals, that nonpublic information that a company had vastly overstated its reported assets and earnings was "material" under antifraud provisions of the federal securities laws.

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In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-276

RAYMOND L. DIRKS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

STATEMENT

1. *Proceedings Below*

Petitioner Raymond L. Dirks caused institutional investors to sell $17 million of securities to uninformed and unsuspecting purchasers by giving these institutional investors inside corporate information that the securities were in fact virtually worthless. Between March 12, 1973, and March 27, 1973, Dirks, a securities analyst, privately informed five institutional investors that Equity Funding Corporation of America ("Equity Funding") had, as a result of fraudulent business practices, vastly overstated its reported assets and earnings. This information had been given to Dirks by former and current Equity Funding employees. Consistent with Dirks' expectation in providing them this nonpublic information, the institu-

tions sold over $17 million of worthless Equity Funding securities, mostly in transactions on the New York Stock Exchange ("NYSE"). Dirks did not report this information about fraud to any law enforcement authorities for three weeks while his tippees traded on the information.

The Commission brought an administrative proceeding against Dirks and the five institutions to determine whether their conduct violated Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Commission Rule 10b-5, 17 C.F.R. 240.10b-5 (J.A. 1-13). The administrative law judge, and the Commission on review (21 SEC Docket 1401), determined that the conduct violated these antifraud provisions. Dirks was censured and four of the institutional investors were also sanctioned. The court of appeals affirmed. 681 F.2d 824.

2. *The Facts*

In March 1973, Dirks was vice-president of a NYSE member broker-dealer firm. Dirks provided investment analysis on insurance company securities to institutional investors that in turn directed brokerage commission business to his firm (J.A. 178; R. 473-76, 1883-87). Dirks also published a "weekly scandal sheet" reporting his analyses to 500 institutional investors from which he hoped to derive brokerage business (J.A. 178; *id.* at 146-48; R. 473-76, 1883-87).

Equity Funding was a California holding company with life insurance subsidiaries chartered in Illinois, New York and other states. Equity Funding's common stock and certain of its debentures were traded on the NYSE. In the 1960's, Equity Funding began to record fictitious life insurance business on its books to inflate the market values of its securities. In about 1970, Equity Funding started selling, through reinsurance arrangements with other life insurance companies, fictitious policies as though they were real (R. 10,772-83).

The practice of selling fictitious policies was like a "Ponzi" scheme,[1] in that Equity Funding was required to reinsure ever greater numbers of policies in order to pay the premiums due on the previously reinsured policies and thereby forestall discovery of its scheme (*id*).[2] Like any Ponzi scheme, the reinsurance scheme eventually had to collapse from its own weight (R. 10,772, 10,780).[3] By early 1973, when Dirks' activities took place, the collapse was apparently near. Almost two-thirds of the insurance reportedly issued by the company was fictitious, and the company was already in such financial distress that management decided to fire 20 percent of its employees (R. 535, 11,033; see also Pet. App. B11 n.19).

Ronald Secrist, a former Equity Funding vice president discharged in Equity Funding's company-wide reduction-in-force, wanted to put an end to these practices (R. 182-83, 509). Based upon gossip at the company, Secrist believed that other employees had previously reported the company's practices to regulatory authorities, including the Commission, but had been "brushed aside with a comment that that's a ridiculous story * * *" (J.A. 16, 22, 25, 66). Secrist decided to report the company's practices to only one regulatory authority—the New York State Insurance Department. Apparently believing that he too might be brushed aside by the regulators, Secrist also decided to reveal the information to

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[1] See *Cunningham* v. *Brown*, 265 U.S. 1 (1924). Dirks himself stated that the fraud was a "short-run [P]onzi-type scheme" (R. 534; see also J.A. 197).

[2] According to the practice in the industry, Equity Funding was required to transmit to its reinsurers 90% of all premium payments made by policy holders on policies that were reinsured. Since there were no policy holders to make premium payments on the fictitious policies, Equity Funding was compelled to generate cash to make payments to its reinsurers or face exposure of its fraud (R. 10,772, 10,780-81; see also Pet. App. B4 n.6).

[3] Equity Funding's bankruptcy reorganization trustee concluded: "Ultimately, the house of cards had to fall" (R. 10,780-81); see also J.A. 124.

Dirks, who Secrist believed would understand his story (J.A. 16, 19). Secrist intended that Dirks would disseminate the information "to his firm's customers," whose trading on the information would "jar" the price of the stock and "finally force [the regulators] to move" (J.A. 16, 25, 26).[4] As it turned out, Secrist was wrong in both his beliefs: no Equity Funding employee had ever reported the company's practices to the Commission, and Secrist's report was not "brushed aside" by the regulators.

A. Secrist Informs the Insurance Regulators, and They Commence an Examination of Equity Funding

During the morning of Wednesday, March 7, 1973, Secrist told the New York insurance regulators that at least one-third of the insurance reportedly issued by Equity Funding's Illinois subsidiary, Equity Funding Life Insurance Company ("EFLIC"), was fictitious, that Equity Funding was reinsuring this fictitious insurance, and that Equity Funding was engaged in other fraudulent practices (J.A. 23, 192-94; R. 219-59, 479-567). He described in detail how top-echelon management, with the cooperation of corrupt auditors, had operated and concealed the fraudulent scheme (*id.*). The New York staff who heard Secrist's story was "convinced" that Secrist was telling "the truth" (J.A. 83-84).

The New York staff concluded that prompt action was in order. They assured themselves that policyholders of Equity Funding's New York subsidiary were not in any immediate danger[5] and referred Secrist's disclosures to the state insurance regulators in California, where Equity

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[4] There is no evidence in the record to suggest that Secrist understood the trading he intended would itself be a violation of the law.

[5] Although Secrist had not said that Equity Funding's New York subsidary was involved in the fraudulent insurance practices, the New York staff made sure that the subsidiary's assets were intact (R. 6907-14).

Funding and EFLIC shared their principal offices.[6] California in turn quickly contacted insurance regulators in Illinois, who shared with California regulatory authority over EFLIC. By Friday, March 9, 1973—two days after Secrist had made his disclosures to the New York insurance authorities—California and Illinois had agreed to assemble a joint team of top insurance examiners to conduct an immediate investigation of Equity Funding[7] under the "guise of a routine examination" of EFLIC.[8]

On Monday, March 12, 1973, two Illinois examiners began an unannounced examination of EFLIC; a California examiner joined the investigation on March 22, 1973, delaying his arrival to make the examination appear routine (J.A. 87-88). The insurance examiners persisted in their investigation despite Equity Funding's attempts to thwart them.[9] They established that over $22 million of EFLIC's assets were missing, and on March 30, 1973, they seized control of EFLIC's operations and Equity Funding's scheme collapsed (J.A. 271; see also *id.* at 89; R. 10,798, 10,805-06).

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[6] The New York officials waited until the next day, March 8, 1973, to transmit the disclosures to the California authorities because they felt that Secrist had talked to them "in strict confidence" and his "permission," which was obtained on that date, was needed to inform others (J.A. 82).

[7] The California investigators were convinced that Secrist's allegations were entirely plausible, particularly since in their view there was "reason to question [the] integrity * * *" of Stanley Goldblum, the president of Equity Funding (J.A. 88; see also *id.* at 98-99). Similarly, Illinois officials found Secrist "rational" and "believable" when they met with him on March 21, 1973 (J.A. 86; R. 7089, 7102).

[8] A California official testified that the states used the pretext of a routine examination because they "didn't want to alert the company for fear that [it] might start destroying records" (J.A. 87).

[9] For example, Equity Funding officials tapped the telephone conversations of the examiners in an attempt to anticipate their investigative steps. The examiners quickly "suspect[ed their] telephone calls [were] being 'monitored'" (R. 12,639; see also R. 10,798), and began using pay telephones (R. 7727).

B. Secrist Informs Dirks, and Dirks Tips His Clients

On March 7, 1973, immediately after meeting with the New York insurance regulators, Secrist met with Dirks and an associate of Dirks who had been an actuary with a life insurance company. Secrist did not reveal that he had just met with the state insurance officials (J.A. 24). In a three-and-one-half-hour conversation Secrist gave Dirks and the associate the same detailed information he had just given to the state insurance authorities (J.A. 23, 192-94; R. 219-59, 479, 567). Secrist described the mechanics of the scheme, stating that he had witnessed and participated in creating bogus insurance files on fictitious policies (R. 224-35, 239-42, 254, 485-86, 525-37).[10] Secrist gave Dirks the names of several other Equity Funding insiders who would corroborate the information (J.A. 228; R. 248, 494-95). Dirks concluded that Secrist's detailed story "held together well under questioning by two insurance analysts" (R. 1642).[11]

At the end of the meeting, Secrist and Dirks spent 20 minutes discussing what Secrist expected Dirks to do with the report (R. 460). Secrist told Dirks his opinion of regulators, including the Commission, and his plan to have Dirks confirm the information and then disseminate it broadly to Dirks' clients (J.A. 15, 25-27).[12] Dirks suggested going to the *Wall Street Journal*

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[10] Secrist explained in detail how management had organized meetings to create fake insurance policy files (R. 239-42) and how employees had returned phony confirmation slips as part of the company's plan to deceive its auditors (R. 230-32). Secrist told Dirks that the insiders called bogus life insurance "Y business," a phrase coined by Art Lewis, EFLIC's chief accountant, after the mathematics symbol for the unknown (R. 237, 244, 441, 480).

[11] See also R. Dirks & L. Gross, *The Great Wall Street Scandal* 90-91 (1974) ("By the end of a four-hour lunch on March 7, it didn't sound all that crazy."). The administrative law judge found that Dirks believed at an early stage that Secrist's report was "probably true" (J.A. 258-60, 295) and that Dirks' contrary testimony was "less than candid" (J.A. 299-300).

[12] See Dirks & Gross, *supra* note 11, at 92.

("*WSJ*") with a view to having the newspaper investigate and publish a story exposing the fraud (J.A. 21-22, 27, 37-38). Dirks said he knew a *WSJ* reporter who "had good contacts with the regulators" (J.A. 37-38).

On Monday, March 12, Dirks quickly ascertained the identities of institutional investors he believed owned Equity Funding securities and began to convey to them the "hard story" about Equity Funding's fictitious insurance (J.A. 230-31; R. 1665-68). He told only a "soft story" about accounting irregularities, or nothing at all, to those who he believed did not own Equity Funding securities (J.A. 210-11, 219-21, 245; R. 4130-34, 4156-57, 4324-27, 4341-43, 4562-66, 4704-06).[13] The Boston Company Institutional Investors, Inc. ("Boston"), sold $1.2 million of its clients' Equity Funding securities based on Secrist's information tipped by Dirks (J.A. 189; R. 2088-2103, 2121-22, 2138-39, 2252-53, 5404-57, 11,451). Boston then directed brokerage business worth $4,000 to Dirks' firm as a direct result of the tip (J.A. 148, 199).[14]

When William Maloney, president of Institutional Capital Corporation, was tipped by Dirks, he asked why Dirks had not reported the information to the NYSE or the Commission; Maloney said that if Secrist's disclosures were true it would be "disastrous" and, if not, spreading the story through the investment community would cause a "tremendous" amount of needless "volatility in the stock" (J.A. 139). After receiving no "satisfactory answer," Maloney advised Dirks that Dirks should at least fly to Los Angeles and confront Equity

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[13] In this proceeding, reports of mere accounting irregularities "came to be known as the 'soft story' in contrast to the 'hard story' reports of widespread fraud involving bogus insurance, forged certificates of deposit, and related details" (J.A. 211 n.24).

[14] The administrative law judge found that this money was received "as a direct consequence of the fraud information," stating that contrary testimony "is not credited" (J.A. 263 and n.48; see also J.A. 199, 204-05).

Funding's management with the allegations (J.A. 140, 233-34).[15]

Dirks arrived in Los Angeles on March 20 and met with William Blundell, bureau chief in the *WSJ*'s Los Angeles office, whom he had alerted to the story (J.A. 233, 238; R. 8681-86).[16] Blundell began his own full-time investigation and quickly "became convinced that the story was true after talking to a couple of people * * * at Equity Funding who admitted * * * that they had engaged in various criminal action[s] and who emotionally broke down about this thing" (J.A. 131; R. 8702). By March 22 or 23, Blundell came to the conclusion that "the SEC ought to know about the information with an eye towards stopping trading in the stock" (J.A. 132).

Between March 20 and 23, Dirks independently interviewed the former and current Equity Funding employees who Secrist had said would corroborate his story.[17] All reported detailed, often first-hand evidence, confirming Secrist's report of widespread fraud at the company (J.A. 234-36, 239-42; R. 784-812, 990-1045, 1055-65).[18] Equity Funding's former controller, Frank Majerus, con-

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[15] Maloney also advised Dirks that Dirks might be violating the proscriptions on insider trading by spreading the information to institutional investors (J.A. 141-42; Pet. App. B17 n.33).

[16] Dirks had attempted to contact a reporter he knew at the *WSJ*'s San Francisco office on March 12, and reached him on March 19 (J.A. 230, 233; R. 780, 1248-49, 1259-60). In accordance with *WSJ* procedures, the story was assigned to Blundell in Los Angeles since Equity Funding was located there (J.A. 233; R. 8722).

[17] Dirks also met with a computer company employee who stated that based upon data he had acquired from Equity Funding's computer he would stake his career on the existence in 1970 of fictitious insurance (J.A. 241; R. 1087-89).

[18] The administrative law judge found that these other insiders confirmed that "the basic allegations of massive insurance fraud at Equity Funding were in fact true * * *," even though their stories contained "some peripheral contradictions" to Secrist's disclosures (J.A. 253 n.42, 260).

fessed to Dirks that he had falsified ledgers in 1970 to conceal the fictitious insurance, adding that he thought he would be "'going to jail'" for his participation in the fraud (J.A. 40, 236). Equity Funding's management denied Secrist's allegations.

From March 20 to March 23, 1973, Dirks continued to divulge the information privately to institutional investors that he knew or suspected owned Equity Funding securities. On March 20, he telephoned Boston, informing its officials of Majerus' confession (J.A. 237; R. 966). The following day, Boston sold its clients' remaining Equity funding holdings for $7.5 million and promised to direct brokerage business worth $25,000 to Dirks' firm (J.A. 237; 11,451). On March 22, 1973, Dirks spoke for 30 minutes with officials of The Dreyfus Corporation about Equity Funding's accounting of earnings, but he never mentioned the "hard story" regarding bogus insurance (J.A. 210-11; R. 4696-4701). After he ascertained that Dreyfus clients actually had Equity Funding holdings, on March 23 Dirks disclosed the "hard story" to Dreyfus (J.A. 211; R. 4562-66).[19]

On Friday, March 23, Blundell told Dirks that he had contacted the Commission about Equity Funding (J.A. 242; R. 1388). Although Dirks concluded that trading would soon be halted (J.A. 244-45), he did not try to contact any regulatory or law enforcement authorities himself.[20] Rather, over the weekend and on Monday, March 26, Dirks continued to supply inside information

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[19] Similarly on March 20 and 22, 1973, Dirks spoke with officials at Tomlin, Zimmerman and Parmelee, Inc., for more than an hour about a possible change in accounting for dividends that could have inflated Equity Funding's 1972 earnings, but he made no mention of the fictitious insurance (J.A. 219-20; R. 972-77). Dirks disclosed the "hard story" to Tomlin, Zimmerman and Parmalee on March 26, 1973 (J.A. 222-25; R. 453-55, 1912-14, 4178, 4364-67).

[20] On March 23, Dirks informed EFLIC's auditors, who decided to begin an "extended audit" of the company rather than to issue an opinion which they had been about to publish (R. 10,984; see also R. 7384).

about Equity Funding's true financial condition to institutional investors, which sold about $9 million of Equity Funding securities on Monday (J.A. 244-45; R. 1142-44, 1387, 3508-09, 4709-13, 11,451).

While Dirks now claims (Br. 12, 38) he was merely contacting "members of the investing community in an attempt to determine if the Secrist allegations could have any substance," there is no evidence he was seeking information from these institutions. When he spoke with personnel of John W. Bristol & Co., he did not seek information or assistance in investigating Equity Funding; he merely advised them that Equity Funding was engaged in fraud, that a halt in trading was imminent, and that if he were in their position " 'he would sell the stock' " (J.A. 207-08; see also R. 1142-44, 4932). When he spoke with officials at Fidelity Management and Research, Dirks did not even relate the report to them because they did not own Equity Funding stock (J.A. 47, 245; R. 1150-51). The administrative law judge found that Dirks' motive was to induce sales on the information and that Dirks acted in the "expectation and belief" that most of his tippees would sell their Equity Funding holdings (J.A. 294-95; see also J.A. 260). Blundell similarly concluded that Dirks' purpose in contacting institutional investors was to protect "some very important clients with a lot of stock," not to obtain information from "portfolio managers who didn't know beans about insurance operations" (J.A. 137-38).

C. Secrist's Information Finally Reaches the Commission

On Friday, March 23, Blundell told Stanley Sporkin, then the Commission's Deputy Director of Enforcement in Washington, D.C., that several Equity Funding employees had reported fraud at the company. According to Blundell, Sporkin stated that the Commission's staff would "get on it right then and sure enough that's what they did" (J.A. 133). The next business day, March 26, attorneys in the Commission's Los Angeles office interviewed Blundell (J.A. 134).

The following morning, March 27, they conducted extensive interviews with Dirks, Majerus, and another former Equity Funding employee (J.A. 164-65; see also Pet. App. B11). This was the first time the Commission obtained information comparable to that provided by Secrist to Dirks on March 7—that is, that a number of former employees knew of fraud at the company, could explain the mechanics of its operation, and were willing to assist in exposing the fraud (J.A. 269-70; see *infra* n.23).

Within a week, the Equity Funding scheme collapsed. On the morning of March 27, while the Commission was interviewing Dirks and the others, the *WSJ* reported in a brief note written by Blundell that "rumors" were circulating that questioned the accuracy of EFLIC's insurance in force and that Equity Funding had denied the rumors as "without foundation" (R. 11,605; see also J.A. 268, 271). Just after 12:30 p.m. Eastern Standard Time on that day, the NYSE halted trading in Equity Funding stock, amid heavy selling by Dirks' tippees and members of Equity Funding's top-level management who attempted to sell their stock before public revelation of the fraud.[21] The next day, Wednesday, March 28, the Commission suspended all trading in Equity Funding securities. As discussed previously, the state insurance regulators seized control of EFLIC's business operations two days later, on March 30, after discovering that over $22 million of EFLIC assets were missing. On the following Monday, April 2, Blundell published a detailed story in the *WSJ*, for the first time publicly exposing the existence of fictitious insurance (R. 11-608-10; see also J.A. 167).[22]

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[21] *Before the Fall: Many Officers Sold Equity Funding Stock Before Scandal Broke*, WSJ, April 20, 1973, at 1; see R. 10,811, 10,814.

[22] The administrative law judge found that "[t]he argument of some Respondents that they believed the inside information they had was already public knowledge is so lacking in support in the

The Commission filed an injunctive action the same day seeking the appointment of a new board of directors and a special investigator, which was ordered the following day (J.A. 167).[23]

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record as to come close to being frivolous" (J.A. 289; cf. *id.* at 143-45).

[23] Regrettably, there has been a misunderstanding as to when the Commission first received information comparable to that conveyed by Secrist to Dirks. In 1971, the staff of the Commission's Los Angles office was informed that William T. Mercado, a high-level Equity Funding officer, had made statements to the effect that the company was manipulating its earnings (J.A. 105, 270 n.49). The Commission's staff sought out Mercado and interviewed him. In contrast to the detailed story provided by Secrist to Dirks, Mercado "did not volunteer any information or come out with any statements regarding what was going on * * *" at the company (J.A. 114; see also *id.* 108, 270 n.49). Indeed, he effectively covered up the fraud. Mercado stated that, although he had noticed "several questionable accounting practices" at Equity Funding when he first joined the company, any accounting irregularities had occurred because the company had been founded by salesmen who did not have qualified accountants advising them and, "[s]ince then, * * * the corporation ha[d] employed qualified accountants" to ensure that it followed proper accounting practices (J.A. 157-58). Mercado assured the staff that, although he was leaving the company under circumstances he described as "not friendly," he had "no reason to believe" that the company was engaging in any questionable practices (J.A. 155-59).

Several months later, Mercado's attorney, James Jess, contacted the Commission's staff, assertedly because of his concern that Mercado might have been questioned improperly without the presence of an attorney (J.A. 160-62). Contrary to Dirks' assertion (Br. 6), the Commission did not reject "an offer" by Jess for Mercado "to provide information about substantial fraud at Equity Funding in exchange for immunity." Although that may have been Jess' plan before meeting with the staff, a contemporaneous memorandum of the meeting indicates that the subject of "immunity" was raised in a very circumspect manner and Jess never stated that Mercado had any information which he had not already supplied to the staff (J.A. 160). The staff contacted several employees other than Mercado, but no one offered information concerning improper practices (J.A. 107-08, 270 n.49).

On March 9, 1973, two days after Secrist had revealed his information to the New York authorities, an attorney with the California

3. *The Commission's Decision*

In its opinion below the Commission found that Dirks had aided and abetted violations of the antifraud provisions by causing sales of $17 million of worthless Equity Funding securities on the basis of material, inside information concerning Equity Funding's true financial condition.[24] The Commission stated that Dirks' tippees' use of material, inside information "in dealing with uninformed public investors constitute[d] an act, practice, or course of conduct which operate[d] as a fraud on investors" in violation of the antifraud provisions (Pet. App. B12). Dirks knew that the information he obtained was nonpublic (*id.* at B20) and he knew or should have known that his disclosures to the institutions would result in trading (*id.* at B22).

Department of Insurance advised a staff member of the Commission's Los Angeles office that an informant had alleged that the company was engaging in fraudulent insurance practices and that the state insurance agencies were going forward with the full investigation discussed previously (J.A. 91-98). The California attorney, who was not part of the team of insurance examiners looking into Equity Funding practices, did not go "into any special detail" about the reinsurance scheme and told the Commission staff member that he "wasn't sure of the name" of the informant, and "wasn't real sure of the fellow's job" (J.A. 94; R. 7717). Nevertheless, according to a contemporaneous memorandum of the meeting, the Commission staff member responded that California should "obtain as much detailed information as possible from the informant and that upon receipt of this information" the Commission and the state agencies would discuss an appropriate method of jointly investigating Equity Funding (J.A. 171-72; see also *id.* at 97). In the memorandum, the Commission's staff member suggested delaying the Commission's participation in the state insurance regulators' investigation only "*if* the informant cannot give detailed information" (J.A. 172 (emphasis supplied)).

[24] Section 15(b) of the Securities Exchange Act, 15 U.S.C. 78*o*(b), provides that the Commission may impose certain sanctions, including a censure, on any person associated with a registered broker-dealer, who has willfullly violated or "willfully aided, abetted, counseled, commanded, induced, or procured * * *" any violation of the federal securities laws.

The Commission found that the information Dirks tipped was material (*id.* at 14-20). The information was "specific and detailed," sharply contrasting with vague rumors that were publicly available in the marketplace, came from a known inside source, and, by March 23, 1973, had been repeatedly corroborated by "detailed, often first-hand" information from other Equity Funding insiders (*id.* at B14-15, B17). "Few disclosures," the Commission found, "could have had a greater impact on the quality of an investment, or on the stability of the market for it, and Dirks and his tippees clearly appreciated that fact" (*id.* at B17). The Commission found that the information was "clearly" and "unquestionably" material during the period from March 23 to March 26 (*id.* at B14-15). The Commission stated that petitioner's censure was warranted on the basis of the $9 million of trades that he fostered during that brief period alone (*id.* at B26 n.54).

The Commission stated that *Chiarella* v. *United States*, 445 U.S. 222 (1980), had confirmed the well-established principles that "corporate insiders" have a duty to disclose or abstain from trading in their corporation's securities on the basis of material inside information and that "tippees," such as Dirks and his clients, "who receive non-public, material information from insiders become 'subject to the same duty as [the] insiders'" (Pet. App. B11-12 & n.21, B21 n.42, quoting *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974)). The Commission found that while Dirks' insider sources were presumably entitled to disclose the Equity Funding fraud in order to bring it to light and its perpetrators to justice, they could not profit secretly from trading with persons who were ignorant of the fraud (Pet. App. B20-21 & n.42). Petitioner "assumed" that duty from Secrist and the other Equity Funding insiders with whom he was dealing (*id.*).

The Commission expressed its full appreciation for the importance of the work of securities analysts in provid-

ing public investors with an accurate factual basis upon which to make their investment decisions. The Commission considered whether its decision would impair the efficiency of the securities markets or discourage securities analysts from actively researching corporations and, especially, investigating allegations of fraud (*id.* at B25-26). The Commission noted that "market efficiency" in the pricing of securities is an important statutory goal that is "significantly enhanced" by the activities of professional analysts in ferreting out and analyzing information relating to the value of securities (*id.* at B12-13). On the other hand, the Commission stated, promoting investor confidence in the fairness of our markets is also an important statutory goal that is significantly impaired when investors trade on material inside information disseminated to them directly or indirectly through analysts (*id.* at B25-26).

To accommodate these two goals—market efficiency and fairness—a line must be drawn (*id.* at B13). The proper line, the Commission explained, permits analysts to sell information they have "create[d]", but not to pass along to clients the type of information that their insider sources are themselves prohibited from using in securities trading (*id.* at B18):

> We have long recognized that an analyst may utilize nonpublic, inside information which in itself is immaterial in order to fill in "interstices in analysis." That process is legitimate even though such "tidbits" of inside information "may assume heightened significance when woven by the skilled analyst into the matrix of knowledge obtained elsewhere," thereby creating material information.

The Commission found that Dirks crossed the boundary of legitimate analysis into unlawful tipping (*id.*):

> [I]t is important to recognize that this is not a case in which a skilled analyst weaves together a series of publicly available facts and non-material inside disclosures to form a "mosaic" which is only material

> after the bits and pieces are assembled into one picture. • • • • •
>
> Secrist's information certainly was not "seemingly inconsequential data." Instead, its significance was immediately clear. Upon receipt of the information from Secrist, there was no need for Dirks to obtain, and he did not obtain, significant new facts to be woven together with Secrist's original allegations. All that occurred was corroboration and confirmation from inside sources of the original allegations.

The Commission concluded that under these circumstances a finding that Dirks aided the institutions in violating the antifraud provisions "will not discourage analysts from engaging in the legitimate and desirable function of seeking out corporate information" (*id.* at B19).

The Commission took into account, as mitigating factors, that Dirks had provided information about the Equity Funding fraud to the *WSJ*, to Equity Funding's auditors, and eventually to the Commission. The Commission determined that some sanction was nonetheless warranted because Dirks had privately advised the institutions of the fraud knowing that they would be able to "trade on the information well before it would become public" (*id.* at B26 n.52). The Commission determined to impose only a censure against him (*id.* at B26).[25]

4. *The Court of Appeals' Decision*

The court of appeals (Wright, Tamm, and Robb, J.J.) entered a judgment without accompanying opinion, denying, "for the reasons stated by the Commission in its opinion," Dirks' petition for review of the Commission's censure order (*id.* at C1-2).[26] Judge Tamm dissented from the judgment.

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[25] Censure is the mildest remedy available to the Commission under Section 15(b).

[26] The judgment also stated Dirks "breached his duty to the Commission and to the public not to misuse insider information and that he was compensated for so doing" (Pet. App. C1-2).

Subsequently, the court of appeals issued an opinion written by Judge Wright (*id.* at A1-41). Judge Robb concurred in the result, and Judge Tamm dissented; neither filed a separate opinion. Judge Wright stated that Dirks' censure should be affirmed on the theory expressed by the Commission that Dirks and his tippees had assumed the "disclose-or-abstain" obligations of their insider sources (*id.* at A15-27, citing *Shapiro* v. *Merrill Lynch*). Judge Wright added that, as an employee of a broker-dealer, Dirks breached ethical duties not to assist his "clients [in] dump[ing] fraudulent securities on an uninformed public" (Pet. App. A3, A27-31).

SUMMARY OF ARGUMENT

1. Dirks inherited the duty of the source of his information, Secrist, not to defraud purchasers of Equity funding securities. Secrist had a duty to disclose the company's true condition to investors before trading with them. That duty rests upon the common law fiduciary relationship between a corporate insider and the stockholders of the corporation rather than upon the separate and distinct duty of the insider to the corporation to preserve the confidentiality of corporate information. Thus, the fact that in this case the information concerning Equity Funding's fraudulent practices was not entitled to confidentiality is irrelevant to Secrist's continuing duty not to disadvantage the company's shareholders.

This Court recognized in *Chiarella* v. *United States*, in discussing the traditional prohibition against insider trading by insiders and their tippees, that the duty to disclose *inside* information arises not from any obligation to the corporate source of the information but from the "relationship between a corporate insider and the stockholders of his corporation." The Court's actual holding did not involve inside information. *Chiarella* held that "a duty to disclose under § 10(b) does not arise from mere possession of nonpublic *market* information." 445

U.S. at 235 (emphasis added). In sharp contrast to Secrist's status as an insider of Equity Funding, the source of the information obtained by Chiarella was not an insider but a proposed tender offeror, who had no fiduciary duty to the target company's shareholders with whom Chiarella traded. Thus there was no duty to be inherited by Chiarella.

In this case the Commission followed *Chiarella*. The Commission's analysis is supported by the common law principles recognized in that decision and by the language and purposes of the antifraud provisions of the federal securities laws. Congress confirmed that approach when in 1975 it comprehensively amended the securities laws.

a. At common law, an officer or director is "a quasi trustee" of the shareholders in his transactions in the shares of the company. *Oliver* v. *Oliver*, 118 Ga. 362, 367 (1903); *Stewart* v. *Harris*, 69 Kan. 498, 504 (1904). He is required to inform his shareholders of the corporation's true condition before trading with them in the corporation's stock, and his failure to do so is fraud. *Strong* v. *Repide*, 213 U.S. 426, 435 (1909). The character of the information, whether a legitimate corporate secret or evidence of crime, is irrelevant to this disclosure duty.

Since corporate officers and directors are forbidden by their trust relationship from using undisclosed corporate information to the disadvantage of their shareholders, they may not give such information to outsiders for the same improper purpose. Cf. *Mosser* v. *Darrow*, 341 U.S. 267, 272 (1951). "Tippees" who knowingly participate with the insiders in such a breach of fiduciary duty are "as forbidden" from taking advantage of shareholders as the insiders themselves. *Id.* Since the disclosure obligation of tippees rests upon the disclosure obligation of the insider to individual shareholders rather than any duty of silence or loyalty to the corporation, the corporation's right to preserve information as a secret is not a prerequisite to the tippee's liability.

Consistent with these common law principles, the Commission held that Dirks' insider sources had a duty to disclose Equity Funding's true financial condition to the company's investors before trading with them, notwithstanding the fact that the truth evidenced criminal conduct. By giving inside information to Dirks with the intent that Dirks and Dirks' tippees use that information to the detriment of Equity Funding investors, Secrist breached his fiduciary duty. As a knowing participant in that breach, Dirks assumed the duties of Secrist. Like Secrist, Dirks owed Equity Funding no duty of confidentiality and was free to report his inside information to any law enforcement authority. Like the insiders, however, he was duty bound not to pass that information on to favored institutions which would be likely to sell their worthless Equity Funding securities to uninformed investors.

b. In adopting Section 17(a) and Section 10(b), Congress embraced and built upon these common law fiduciary principles. Imposition of tippee liability on Dirks is consistent with the broad language of the antifraud provisions, and necessary to achieve Congress' purpose of eliminating the abuses of insider trading for the protection of investors and the maintenance of investor confidence in the integrity of the trading markets.

c. Congress has confirmed that the Commission has correctly interpreted its legislative intent. When Congress revisited the subject of informational advantages in the comprehensive Securities Acts Amendments of 1975, it left intact the consistent and widely-known Commission and judicial decisions holding that insiders and tippees are prohibited by the antifraud provisions from using inside information to the disadvantage of uninformed investors, whether or not the corporation is entitled to keep the information secret.

2. The public's interest in promoting effective law enforcement does not warrant the creation of an exception to the insider trading prohibitions for inside information

that evidences possible illegal conduct. First, such an exception would encourage tippees to withhold the information not only from persons with whom they trade but also from law enforcement authorities. Because information loses its value in the market when it is generally known, the "last thing that a man with information of Wall Street wants to do is make that information public." Dirks & Gross, *supra* n.11 at 282. The proposed exception thus runs afoul of the "deeply rooted social obligation" to report information evidencing criminal conduct to law enforcement officials, *Roberts* v. *United States*, 445 U.S. 552, 558 (1980), and the common law policy against permitting citizens to "convert [knowledge of] crime to a source of profit or benefit * * *." *Williams* v. *Bayley*, L.R. 1 H.L. 200, 220 (1866). Adoption of this exception would be more likely to impede, than to promote, effective law enforcement.

Second, the exception would lead to uncertainty. Tippees are in a poor position to distinguish criminal conduct from the many corporate activities that are within a broad "'gray zone of socially acceptable and economically justifiable business conduct,'" *Upjohn* v. *United States*, 449 U.S. 383 (1981), quoting *United States* v. *United States Gypsum Co.*, 438 U.S. 422, 440-41 (1978). Tippees would necessarily act at their peril in trading on the basis of such undisclosed information.

3. The Commission, the trier of fact, found that the information Dirks tipped was material—that is, that it would have been important to a reasonable investor in making an investment decision. *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976). The court of appeals held that the Commission's materiality finding was supported by substantial evidence, and that determination is conclusive absent extraordinary circumstances. *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 491 (1951).

ARGUMENT

I. THE TRADITIONAL INSIDER TRADING PROHIBITION APPLIES TO DIRKS SINCE HE INHERITED THE DUTY OF THE EQUITY FUNDING INSIDERS NOT TO PARTICIPATE IN DEFRAUDING THE COMPANY'S INVESTORS; THAT THE TRADING IN THIS CASE WAS BASED ON INFORMATION RELATING TO CRIMINAL CONDUCT DID NOT OUST THAT PROHIBITION

It is well settled that a corporate insider's or tippee's failure to disclose material inside information before trading with investors is fraudulent conduct prohibited by Section 17(a) and Rule 10b-5. This insider trading prohibition comports with traditional fiduciary principles and serves to protect the integrity of the securities markets. The Commission applied this prohibition to Dirks. It held that Dirks, "standing in [the] shoes" of his insider sources, "committed a breach of the fiduciary duty which he had assumed in dealing with them, when he passed [inside] information on to traders" who, consistent with his expectations, sold worthless securities to uninformed investors (Pet. App. B21 n.42).

Neither Dirks nor the Solicitor General, who has filed a brief as amicus curiae in support of reversal on this issue, disputes the general applicability of the insider trading prohibition. Rather, they contend that there should be an exception from that doctrine here because the undisclosed inside information was evidence of crime instead of "[l]egitimate" inside information "properly kept confidential for the benefit of the corporation" (Dirks Br. 28; see *id.* at 22-23; S.G. Br. 24 n.16).[27] The requested exception is without foundation.

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[27] In addition to Dirks' attack on the Commission's duty analysis, which we discuss in the text, Dirks also attacks (Br. 31-34) Judge Wright's alternate theory that Dirks, as an employee of a broker-dealer firm registered with the Commission, had a special duty to disclose or abstain from trading. However, the Commission did not consider Judge Wright's alternate theory in its decision, nor did it present that theory to the court of appeals. Its merits are

Dirks and the Solicitor General erroneously rely on this Court's decision in *Chiarella* in making their argument. They concede that there is no conflict between the Commission's decision here and *Chiarella*'s actual holding, and this Court's recognition there of the insider trading principles supports the Commission's decision in this case. Moreover, there is nothing in the opinion even remotely suggesting that these principles should be ousted when the inside information shows criminal wrongdoing.

Chiarella did not involve inside information of any type. *Chiarella* held that "a duty to disclose under § 10(b) does not arise from mere possession of nonpublic *market* information"—that is, information originating outside the company and usually about the supply and demand for the company's securities. 445 U.S. at 235 (emphasis supplied). See also *id.* at 231 n.13. In *Chiarella*, the source of the information obtained by Chiarella was a prospective tender offeror, not the target company whose shares Chiarella traded. The tender offeror had no fiduciary duty to the target company shareholders

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therefore not before this Court. *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947). The Solicitor General agrees (Br. 12-13 n.4) that in light of *SEC* v. *Chenery* "there is no need for the Court to consider this alternate theory of liability * * *."

Amicus Securities Industry Association ("SIA") limits its brief (Br. 19) to the argument that this Court should reject Judge Wright's alternative view. The SIA argues that Judge Wright's theory is incorrect because, among other reasons, it requires an analyst to disclose before trading or transmitting to his clients for their trading purposes material nonpublic information "[r]egardless of whether inside information is involved or the analyst has any nexus to the corporation or its insiders * * *." This position is consistent with the position that the SIA took as amicus curiae in *Chiarella*, where it argued that imposition of a general duty to disclose *market* information (see *infra* p. 22) would disrupt normal activities of securities professionals. However, the SIA in *Chiarella* had no quarrel with the proposition involved here that "traditional corporate insiders * * * or those who derive inside information from them, a class of persons as to whom the imputation of a duty to speak * * * is surely appropriate," may not profit on inside information. SIA Brief in *Chiarella* at 27-28.

to disclose its information before trading with them and was also free, under the law at the time,[28] to transmit the information to institutional investors for their trading purposes. 445 U.S. at 231, 232-33. Accordingly, there was no disclosure duty to be assumed or inherited by Chiarella. In sharp contrast, the sources of the information here did have a disclosure duty which could be inherited; they were Equity Funding insiders who owed a fiduciary duty to the company's investors to disclose, before trading with them, *inside* information—that is, information generated within the company relating to its assets or earnings. Indeed, Dirks and the Solicitor General do not dispute that Secrist and Dirks' other insider sources had a duty to investors to disclose the information involved here before trading with them, notwithstanding that it evidenced crime.

In relying on *Chiarella* to support their contention that the duty to disclose information evidencing a crime cannot be inherited, Dirks and the Solicitor General misread the decision. *Chiarella* discussed two separate doctrines under which a duty to disclose may arise. One, what might be called a "misappropriation" doctrine, imposes a duty to disclose information that has been obtained by theft or other misappropriation, even if the source of the information did not himself have any duty to those with whom he might trade. 445 U.S. at 239-43. Under that doctrine the fact that information evidences crime is arguably relevant on the theory that such information cannot be the "private property of anyone" or "amenable to 'conversion'" (S.G. Br. 22-23). The Commission did not, however, apply any misappropriation principle in this case.[29] The second doctrine was the

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[28] After *Chiarella*, the Commission promulgated Rule 14a-3(c) prohibiting certain kinds of trading on nonpublic information regarding upcoming tender offers. See *Chiarella*, 445 U.S. at 234 n.18; 45 Fed. Reg. 60410 (1980).

[29] The Commission agrees that a person who steals or misappropriates secret information that is material to the value of a publicly traded security should not be permitted to use that information in

traditional prohibition, discussed with approval by this Court in *Chiarella*, against trading on inside information. 445 U.S. at 226-30 & n.12. That doctrine, which imposes liability on both insiders and their tippees, is the basis of this case.

Under that doctrine, the fact that the inside information in this case evidences crime, and thus may not be subject to misappropriation, is irrelevant. The disclosure duty here does not rest on a breach of any obligation to the source of the information, but rather on an independent disclosure obligation to the investor who is buying or selling the security. The pervasive flaw in the argument advanced by Dirks and the Solicitor General is their failure to recognize that fundamental distinction.

Chiarella recognized that the duty to disclose inside information arises not from any obligation to the corporate source of the information but from the "relationship between a corporate insider and *the stockholders* of his corporation." 445 U.S. at 227 (emphasis supplied). When this Court mentioned that the tippee's obligation had been viewed as arising from his role as a participant in an insider's "breach of a fiduciary duty," it did not suggest that the beneficiary of that duty was the corporate entity. See 445 U.S. at 230 n.12. Likewise, when the Commission and the lower courts have considered tippee liability in their decisions, they have focused on the relationship between the insider and shareholder as the source of the duty to disclose inside information, and not on the corporate entity's right

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trading in the securities markets. The Court in *Chiarella* did not hold Chiarella liable under that doctrine since it had not been adequately presented to the jury in that criminal case. 445 U.S. at 235-37; see also 445 U.S. at 238 (concurring opinion); 445 U.S. at 239 (concurring opinion); 445 U.S. at 239-43 (dissenting opinion); 445 U.S. at 243-45 (dissenting opinion).

The Commission in this case did not premise liability on a theory that Dirks used the information beyond the purpose intended by Secrist. In an appropriate case, misuse of information given for a limited purpose would be a form of misappropriation.

or interest in preserving the information as a secret. See *infra*, p. 36.

In this case, the Commission followed *Chiarella*. While Equity Funding had no right to keep secret the information that it had fraudulently inflated its reported assets and earnings, that circumstance was not relevant to an insider's or tippee's duty to disclose before trading with Equity Funding investors. As the Commission stated:

> It is one thing to relieve a corporate insider of his duty of confidentiality to the extent necessary to inform the proper authorities where improper or illegal conduct is taking place within the corporation. It is, however, quite another matter to allow the insider to profit by trading on the information himself—or to allow the insider's tippee to divulge it to those who may trade or tip traders.

Pet. App. B20-21. The Commission thus found that Dirks assumed a fiduciary duty running to Equity Funding investors when he knowingly received from the company's insiders nonpublic inside information and that he committed a breach of that duty "when he passed the information on to traders" expecting them to trade (*id.* at B21 n.42).

A. The common law antecedents of the antifraud provisions support the Commission's decision

Since the language of Section 17(a) and Section 10(b) does not explicitly address when nondisclosure is fraudulent (see *Chiarella*, 445 U.S. at 226), it is appropriate to look to the common law antecedents of these provisions to ascertain the meaning of the language chosen by Congress. Under the common law principles recognized in *Chiarella*, a corporate insider owed a fiduciary duty to individual shareholders with whom he traded to disclose all corporate information that would be important to their investment judgment about the company's securities. He also owed a duty to his corporation not to misappropriate its assets or breach its legitimate confidences.

These two sets of duties are distinct. The duties running to the corporation protect its interest in preserving its assets, while the duties running to the shareholders protect their personal interests in their stock. The insider defrauds the shareholder[30] by failing to disclose inside information to him before dealing with him in the stock, regardless of whether the corporation has an interest, legitimate or illegitimate, in maintaining the confidentiality of the information or whether the information is a corporate asset capable of being misappropriated. The tippee's disclosure duty rests upon the insider's duty of disclosure to his shareholder, not upon any duty of silence owed to his corporation.

1. Prior to 1900, the common law regarded corporate officers and directors as standing in a fiduciary relation to their corporation in their dealings with corporate property, but not to stockholders in their transactions in the corporation's stock. As agents of the entity, corporate officers and directors owed their corporation fiduciary duties to preserve its assets and to maintain its secrets. See generally 2 J. Pomeroy, *Equity Jurisprudence* §§ 1088-94 (2d ed. 1892); *Restatement (Second) of Agency* § 395 (1976); *Restatement of Restitution* § 200 comment a (1936). They were not precluded by their fiduciary duties to their corporation from trading in the corporation's stock on the basis of nonpublic corporate information, since, as a general matter, such information was not considered a corporate asset or opportunity. See 2. J. Pomeroy, *supra*, at § 1090.[31] Since officers and directors

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[30] Under the securities laws, this principle applies to prospective shareholders as well, *i.e.*, purchasers. See *infra* n.40.

[31] As late as 1949, the Delaware Court of Chancery remarked that, "in the absence of special circumstances, corporate officers and directors may purchase and sell its capital stock at will, and without any liability to the corporation." *Brophy* v. *Cities Services Co.*, 31 Del. Ch. 241, 245, 70 A.2d 5, 8 (1949). A "special circumstance" arises, for example, when the corporation intends to purchase its own stock secretly and the officer or director learns of that intention in the course of his relationship with the corporation; in such

did not stand in a fiduciary relation to individual shareholders, they were free to trade with shareholders without disclosing nonpublic information affecting the value of their stock. See *Walsh* v. *Goulden*, 130 Mich. 531, 539, 90 N.W. 406, 410 (1902); *Board of Commissioners* v. *Reynolds*, 44 Ind. 509, 513, 516 (1873); Cary, *Corporations* 700-02 (4th ed. 1969).[32]

In 1903 and 1904, the Supreme Courts of Georgia and Kansas first recognized an independent fiduciary duty

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a case, the officer's or director's use of the information is adverse to the corporation's interest in acquiring stock cheaply. *Brophy*, 31 Del. Ch. at 245, 70 A.2d at 8. See also *Freeman* v. *Decio*, 584 F.2d 186, 196 (7th Cir. 1978) (corporation has no right of action for insider trading under Indiana law); *Schein* v. *Chasen*, 313 So. 2d 739, 746 (Fla. 1975) (same under Florida law), following certification after remand in *Lehman Brothers* v. *Schein*, 416 U.S. 386 (1974), which vacated *Schein* v. *Chasen*, 478 F.2d 817 (2d Cir. 1973); Brudney & Clark, *A New Look At Corporate Opportunities*, 94 Harv. L. Rev. 997, 1014-15 (1981). In 1969, well after the Commission and the courts had developed the insider trading principles involved here, the New York Court of Appeals recognized a corporation's right to sue insiders who trade on nonpublic corporate information. *Diamond* v. *Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910 (1969). *Diamond* has not been adopted by any other state. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 Mich. L. Rev. 1051, 1070 n.50 (1982).

Dirks erroneously contends (Br. 26 and n.14) that the Commission's decision in this case is "sharply at odds" with *Walton* v. *Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980). *Walton*, however, merely follows the common law principle that, except in special circumstances, a corporation has no right of action to recover profits made from use of inside information in transactions with the company's investors. *Walton*, an action brought on behalf of the corporation itself, did not consider whether a recipient of such information owes a duty of disclosure to those with whom he trades.

[32] As the Supreme Court of Washington summarized the law, " '[t]he doctrine that officers and directors are trustees of stockholders applies only in respect to their acts relating to the property or business of the corporation. It does not extend to their private dealings with stockholders or others, though in such dealings they take advantage of knowledge gained through their official position.' " *O'Neile* v. *Ternes*, 32 Wash. 528, 541, 73 P. 692, 696-97 (1903) (quoting 21 American & English Encyclopedia of Law 898 (2d ed.)).

running from the corporate officers and directors to individual shareholders with whom they traded in the corporation's stock. *Oliver* v. *Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Stewart* v. *Harris*, 69 Kan. 498, 77 P. 277 (1904). These courts held that an officer or director is "a quasi trustee as to the shareholder's interest in the shares." *Oliver*, 118 Ga. at 367, 45 S.E. at 234; see *Stewart*, 69 Kan. at 504, 77 P. at 279. They held that, while he is not forbidden to deal with shareholders, an officer's or director's relationship of trust requires him to "inform such stockholders of the true condition of the affairs of the corporation" before trading with them. *Stewart*, 69 Kan. at 508, 77 P. at 281; see *Oliver*, 118 Ga. at 367-68, 45 S.E. at 234. By 1909, this Court had adopted this fiduciary principle, setting aside a purchase of stock by a director on the ground that he had failed to disclose to the shareholder-seller material facts bearing upon the value of the stock. *Strong* v. *Repide*, 213 U.S. 419, 431-35. This Court described the director's silence as "fraud" in "legal effect." 213 U.S. at 435.[33]

These early decisions make clear that the insider's fiduciary duty running to shareholders is distinct from his fiduciary duties to his corporation. The Supreme Court of Georgia explained the relationship between these two duties:

> It might be that the director was in possession of information which his duty to the company requires him to keep secret; and if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder

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[33] Recognition of a right of action by a defrauded shareholder did not alter the law that the corporation could not recover for an insider's use of nonpublic information absent some tangible injury to it resulting from the insider's trades: " 'the directors and managing officers occupy the position of *quasi*-trustees toward the stockholders alone, and not at all towards the corporation, with respect to their shares of stock.' " *Stewart* v. *Harris*, 69 Kan. at 504, 77 P. 279, quoting 2 J. Pomeroy, *Equity Jurisprudence* § 1090 (2d ed. 1892).

> of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his own advantage, and to the disadvantage of one whom he also represents. * * * If, however, the fact within the knowledge of the director is of a character calculated to affect the selling price, and can, without detriment to the interest of the company, be imparted to the shareholder, the director, before he buys, is bound to make a full disclosure.

Oliver, 118 Ga. at 368, 45 S.E. at 234. Therefore, an insider cannot defend his nondisclosure to a shareholder by arguing that a duty of silence was owed the corporation. Nor can he argue that the information was not a corporate secret and could have been obtained by the shareholder if he had merely asked. *Stewart*, 69 Kan. at 508, 77 P. at 281.

Consistent with these principles, the Commission correctly determined that whether Equity Funding was entitled to keep the information confidential was irrelevant to the insider's duty to disclose that information before trading with shareholders. While Equity Funding insiders in this case owed no duty of silence to Equity Funding, they did owe a duty of disclosure to the company's shareholders which prevented them from selling worthless stock to the shareholders without disclosure of the true financial condition of the company. As the Solicitor General agrees (Br. 19 n.12),

> regardless of the classification of information as inside information * * * or evidence of crime, a fiduciary would not be permitted to take advantage of uninformed beneficiaries by dealing with them in securities transactions. For example, Ronald Secrist and the other officers and employees of Equity Funding were disabled from profiting at the expense of shareholders without full disclosure.

Thus, Secrist could not have sold $17 million of Equity Funding shares, even if his stated purpose was to alert the regulators as a result of the market impact of his

sales and his $17 million profit was said to be only a by-product of his service to society.

2. Just as Secrist could not trade, his tippee Dirks could not trade, and Dirks' tippees could not trade. If officers and directors are forbidden by trust principles from using undisclosed corporate information to the disadvantage of their shareholders in stock transactions, they may not provide such information to others to victimize the shareholders. "[T]hat which the trustee has no right to do he has no right to authorize." *Mosser* v. *Darrow*, 341 U.S. 267, 272 (1951). Further, the transactions of all who knowingly participate with the trustee in such a breach are "as forbidden" as transactions "on behalf of the trustee himself." *Id.*[34] As the Court explained in *Mosser*, a contrary rule "would open up opportunities for devious dealings in the name of the others that the trustee could not conduct in his own." 341 U.S. at 271. See also *SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir.) ("[W]ithout such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given."), cert. denied, 404 U.S. 1005 (1971).[35]

Under these principles, an insider violates a fiduciary duty to the corporation's shareholders by transmitting

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[34] See also *Jackson* v. *Smith*, 254 U.S. 586, 589 (1921) (all who knowingly participate with a trustee in a breach of duty toward the trustee's beneficiary are jointly and severally liable to the beneficiary for all their profits); *Jackson* v. *Ludeling*, 88 U.S. 616, 629, 631 (1874) (outsiders who join corporate insiders in a breach of duty are liable to shareholders); *Restatement (Second) of Agency* §§ 387, 391 (an agent cannot help another take advantage of his principal).

[35] The language in the text from *Texas Gulf Sulphur* related to the court of appeals' affirmance of an order imposing liability on a tippor for the amount of his tippee's profits. 446 F.2d at 1306, 1308.

nonpublic corporate information to an outsider when he has reason to believe that the outsider will take advantage of the shareholders. The outsider who uses the nonpublic information by trading with a shareholder is a participant in the insider's breach of duty to the shareholder, and thus violates his inherited obligation to the shareholder when he is on notice that the insider is himself disabled from using the information without disclosure.

The present case falls within these principles. Secrist was disabled by these trust principles—carried forward and strengthened in the federal securities laws (see *infra* p. 32)—from using his knowledge of material facts concerning Equity Funding's true financial condition in securities transactions with investors, and Dirks was on notice of this disability. Further, as Dirks and the Solicitor General concede, Secrist intended Dirks and his clients to use the information he gave them to the disadvantage of purchasers of Equity Funding securities (Dirks Br. 25 n.13; S.G. Br. 24).[36] Thus, regardless of any ultimate motive to bring to public attention the derelictions at Equity Funding, Secrist breached his duty to Equity Funding shareholders.

Standing in Secrist's shoes, Dirks owed no duty to Equity Funding to maintain the confidentiality of corporate information that evidenced criminal conduct. He was free to transmit the information to the FBI, the Commission, the NYSE or any other law enforcement authority, although he did not do so. But like Secrist, who violated his fiduciary duty in giving Dirks the information, Dirks was forbidden to "pass[] the information on to traders" with the expectation of their trading, and that is exactly why he was censured (Pet. App. B21 n.42).

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[36] The Solicitor General states (Br. 24) "the record establishes unequivocally that [Dirks] used the information in precisely the manner intended by [Secrist] * * *—to divulge the information to institutional traders who would precipitate large-scale market activity * * *."

B. The language of the antifraud provisions supports the Commission's decision

In enacting Section 17(a) and Section 10(b), Congress intended to adopt and build upon the foregoing common law developments. *Herman & MacLean* v. *Huddleston*, No. 81-680 (U.S. Jan. 24, 1983) slip op. 13 ("an important purpose of the federal securities laws was to rectify perceived deficiencies in the available common law protections"); *Foremost-McKesson, Inc.* v. *Provident Securities Co.*, 423 U.S. 232, 255 (1976); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).[37] Congress drafted these provisions broadly to prohibit any species of fraudulent nondisclosure, including the fraudulent practices by insiders and their tippees discussed above. As this Court recently again emphasized, the securities laws combating fraud should be construed broadly to effectuate their remedial purposes. *Herman & MacLean*, slip op. 10-11.

Just as nothing in the common law suggests that violation of a corporation's business or property interests is a prerequisite to insider or tippee liability, nothing in the language of Section 17(a) or Section 10(b) suggests such a requirement. Section 17(a)(3) of the 1933 Act makes it unlawful for "any person," "directly or indirectly," "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" of a security. This language focuses "upon the *effect* of particular conduct on members of the investing public * * *." *Aaron* v.

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[37] See also *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934) (The "constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting'—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system * * *.").

SEC, 446 U.S. 680, 697 (1980) (emphasis in original). Section 10(b) and Rule 10b-5 thereunder make it unlawful for "any person" to use or employ "directly or indirectly" any "deceptive device or contrivance" in the purchase or sale of any security. This language covers all frauds touching on securities transactions.[38] Nothing in the language of these provisions conditions an insider trading violation on the infringement of some legitimate interest of a nontrading corporate issuer.

C. The Commission's interpretation is consistent with Congress' purpose in enacting the antifraud provisions and has been confirmed by Congress

1. The Commission's decision not only finds support in the common law and the language of the antifraud provisions themselves, but also effectuates the purposes of the securities laws.[39] The Securities Exchange Act was designed "to prevent inequitable and unfair practices" (15 U.S.C. 78 (preamble)) and "to insure the maintenance of fair and honest markets" in securities transactions, Section 2, 15 U.S.C. 78b. One objective was to curb the misuse of inside information which in Congress' view had eroded investor confidence in the securities markets and thus capital formation. See S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934) ("The unfair methods of speculation employed by * * * those possessing inside information regarding corporate affairs * * * have also been contributing causes of losses to investors."); accord *id.* at 9; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11, 13 (1934). Congress relied in large measure on the general antifraud provisions at issue here to prohibit use of inside information. See *Foremost-McKesson, Inc.*, 423 U.S. at 255.

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[38] *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971).

[39] A Commission interpretation like the present one, which is compatible with the text and purpose of the securties laws, is entitled to deference. See *E.I. du Pont de Nemours & Co.* v. *Collins*, 432 U.S. 46, 54-55 (1977); *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694, 718-19 (1975).

Congress' purposes fully support the Commission's conclusion that in knowingly receiving material inside information from Secrist, Dirks became subject to the same duty as Secrist. Under his own view of the facts, Dirks participated in a breach of Secrist's fiduciary duty to Equity Funding investors when he carried out Secrist's plan of inducing large sales of worthless securities to those investors on the basis of inside information.[40] As we have discussed, Dirks would be liable under these circumstances even under common law principles, and certainly under the federal securities laws.[41]

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[40] Although Dirks' tippees sold Equity Funding stock to purchasers who may not already have been shareholders (J.A. 245-46), this fact is not significant. In the words of Judge Learned Hand, " 'the director or officer assume[s] a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one." *Chiarella*, 445 U.S. at 227 n.8, quoting *Gratz* v. *Claughton*, 187 F.2d 46, 49 (2d Cir.), cert. denied, 341 U.S. 920 (1951). Moreover, the antifraud provisions protect "purchasers" and "sellers."

[41] Dirks would be liable even if he had obtained the information from Secrist for a proper, non-trading purpose (and thus without a breach of fiduciary duty by Secrist) and thereafter used the information to the disadvantage of Equity Funding investors. The Commission's opinion properly drew no distinction between the two situations, holding that a person who knowingly receives material corporate information in his dealings with insiders becomes " 'subject to the same duty as [the] insiders' " (Pet. App. B21 n.42, quoting *Shapiro*, 495 F.2d at 237).

To recognize such a distinction would nullify Congress' purpose of prohibiting "those possessing inside information regarding corporate affairs" from using that information to the detriment of public investors. S. Rep. No. 792, *supra*, at 3. If insider trading liability did not exist when the information was transmitted for a proper purpose but used wrongfully, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information. A rule against tippee trading in this context is thus necessary to " 'make securities regulation and control reasonably complete and effective.' " *Herman*

It is unimportant from the perspective of Congress' purpose whether the inside information is properly entitled to confidentiality. Since Congress intended to protect purchasers and sellers of securities, not the issuer corporation, from the evils of the use of inside information, the corporation's interest in keeping inside information confidential is simply irrelevant.

2. The principles relied upon by the Commission have been confirmed by Congress. When Congress comprehensively revised the securities laws in 1975,[42] a consistent line of administrative and judicial decisions had established, as a widely-known tenet of the securities laws, that any person knowingly receiving nonpublic corporate information from an insider is prohibited from using that information in trading with the corporation's investors. These decisions did not turn on whether the in-

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& MacLean, slip op. 10, quoting Section 2 of the Securities Exchange Act, 15 U.S.C. 78b.

As the Solicitor General recognizes, *Chiarella* did not attempt to limit tippee liability to circumstances in which the tippee receives inside information through a breach of the insider's fiduciary duty. Br. at 15 n.6, citing *SEC* v. *Lund*, [1981-1982] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. Jan. 22, 1982).

[42] This Court noted in *Herman & MacLean*, slip op. 9, that the Securities Acts Amendments of 1975 constituted the " 'most substantial and significant revision of this country's Federal securities laws since the passage of the Securities Exchange Act in 1934' ", quoting Securities Acts Amendments of 1975: Hearings on S. 249 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess. 1 (1975).

The 1975 amendments were based upon a comprehensive 10-year examination of the need for change in the federal securities law. See H.R. Rep. No. 123, 94th Cong., 1st Sess. 46 (1975); H.R. Rep. No. 229, 94th Cong., 1st Sess. 91 (1975) (Conference Report); *Securities Acts Amendments of 1975, Statement by the President on Signing the Bill into Law*, 11 Weekly Comp. Pres. Doc. 600, June 5, 1975.

formation had a positive or negative impact on the price of the securities or on whether the corporation had any right to maintain the confidentiality of the information.

These leading tippee decisions recognized that selective dissemination of corporate information that is material to the value of the corporation's stock is improper because it violates a duty running to the shareholders, not because it violates some corporate interest or expectancy in secrecy. For example, in the seminal tippee case, *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), the Commission held that a partner in a brokerage firm violated Section 17(a) and Section 10(b) when he sold stock after a director of the issuer told him that his company was about to announce a reduction in its quarterly dividend. The company did not regard that negative information as a corporate asset or a corporate secret; indeed, it had already transmitted the information to Western Union for dissemination when the partner traded. 40 S.E.C. at 909. In *Investors Management Co.*, 44 S.E.C. 633, 635 (1971), and *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 44 S.E.C. 933 (1971), the Commission held liable under the antifraud provisions a broker-dealer tippor and its institutional-investor tippees which sold stock based upon nonpublic negative earnings information that the broker-dealer had received in its capacity as a prospective underwriter for the issuer. As in *Cady, Roberts*, the negative information had no value to the corporation. Indeed, the issuer publicly disclosed the information three days after it had been transmitted to the prospective underwriter. 44 S.E.C. at 636. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, involved the same negative earnings information that was involved in the Commission's *Investors Management* and *Merrill Lynch* decisions. The Second Circuit held that when the tippee knows "the confidential corporate source of the * * * information and * * * its nonpublic nature, [he is] under a duty not to trade in [the issuer's] stock without publicly disclosing such information." 495 F.2d at 238.

Prior to 1975 Congress directed comprehensive studies covering the subject of informational advantages.[43] As a result of these studies, Congress was advised that the antifraud provisions had been interpreted as prohibiting "*any* person from engaging in securities transactions on the material [inside] corporate information, if the information has not been publicly disclosed." *Institutional Investor Study Report of the Securities and Exchange Commission*, H.R. Doc. No. 62, 92d Cong., 1st Sess. 2538 (1971) (emphasis in original). These studies contained detailed discussions of the Commission's decisions in *Cady, Roberts; Merrill Lynch;* and *Investors Management.* See *Institutional Investor Study* 2538-39.

When Congress revisited the subject of informational advantages in the Securities Acts Amendments of 1975, it reaffirmed that ensuring that "dealing in securities is fair and without undue preferences or advantages among investors" is one of the "basic goals" of the federal securities laws. H.R. Rep. No. 229, 94th Cong., 1st Sess. 91 (1975) (Conference Report). Based upon the prior studies that it had directed,[44] Congress left intact the Commission's interpretation that the antifraud provisions prohibited all knowing recipients of material inside information from using such information to the disadvantage of uninformed investors. It also strengthened and expanded regulation of the use of market information, adding specific legislation that granted the Commission authority to control use of market information by stock exchange members. See Section 11(a) of the

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[43] See *Institutional Investor Study Report of the Securities and Exchange Commission*, H.R. Doc. No. 62, 92d Cong., 1st Sess. (1971); *Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. III (1963); *id.* at 157-60.

[44] The Securities Acts Amendments of 1975 "follow[] and reflect[] the conclusions of a long line of studies of our capital markets beginning in the early 1960s," including the *Institutional Investor Study*. H.R. Rep. No. 123, 94th Cong., 1st Sess. 46-47 (1975).

Securities Exchange Act.[45] Congress' decision to leave "intact" the traditional insider trading doctrine, while reshaping the law in the area of informational advantakes in other respects, is strong evidence that it "ratified" the existing administrative and judicial interpretation of the law on insider trading. *Herman & MacLean*, slip op. 9-10; see also *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, No. 80-203 (May 3, 1982) slip op. 24, 28.

II. NO POLICY JUSTIFICATION HAS BEEN SHOWN FOR THIS COURT TO CREATE AN EXCEPTION TO PERMIT INSIDER TRADING ON INFORMATION CONCERNING CRIMINAL WRONGDOING

Dirks (Br. 28-31) and the Solicitor General (Br. 26-30) have not carried the burden of their argument for an exception to the rules against insider trading on the supposition that application of those rules to information about crime will adversely affect criminal law enforcement and the customary functions of securities analysts. They assume incorrectly that law enforcement officials in this case did not act quickly enough[46] and ask this Court

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[45] See also H.R. Rep. No. 123, 94th Cong., 1st Sess. 55 (1975); S. Rep. No. 75, 94th Cong., 1st Sess. 67-69 (1975).

[46] As we have shown in the factual statement, once the regulatory authorities had the detailed information Dirks possessed, they took prompt steps to protect investors and policyholders and put a stop to the fraud. This suggests that the three-week period during which Dirks kept the information from the authorities delayed the eventual corrective actions and public disclosure of the fraud. Thus, Dirks' argument that the sales he fostered were the sine qua non of the termination of the fraud is not supported in the record and must be rejected.

His argument also ignores the "Ponzi-like" nature of the scheme. After an exhaustive examination of the company's affairs, Equity Funding's trustee concluded that the company's fraud was not a brilliant computer fraud that "baffled the world" but simply a "hand-to-mouth" scheme that avoided "detection as long as it did mainly because of audacity and luck" (R. 10,837-41). California's Chief Deputy Insurance Commissioner likewise testified that "[t]he

to provide a rule that would permit tippees like Dirks to profit from inside information about possible illegal conduct without reporting that information to law enforcement officials. As we demonstrate, such an exception, which would run afoul of deeply embedded common law traditions, would encourage insiders and tippees to withhold information from law enforcement authorities. Similarly, they have not shown that the Commission's decision in this case will inhibit analysts' customary research functions or impair market efficiency.

Concealing knowledge of crime from law enforcement authorities, as the Solicitor General acknowledges (Br. 23), has been condemned throughout our history. *Roberts* v. *United States*, 445 U.S. 552, 557 (1980); *Branzburg* v. *Hayes*, 408 U.S. 665, 697 (1972). Under the common law, all citizens had an affirmative duty to report facts about a felony to government authorities or be guilty of misprision of a felony.[47] The common law imposed this duty to prevent private citizens from taking the law into their own hands. See 2 W. Holdsworth, *History of English Law* 99-102 (3d ed. 1927). For the same reasons, failures to report crime to the authorities are still disfavored and persons are rarely excused from the "deeply rooted social obligation" to transmit such information to

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house of cards began to collapse because the logistics were too difficult to manage" (R. 12,424). The scheme "would finally have collapsed of its own mushrooming weight and the fumblings of its perpetrators * * *." M. Comer. *Corporate Fraud* 185 (1977), quoting Blundell, *Equity Funding Trustee Calls the Fraud Inept, Slapdash, and Assails the Auditors*, WSJ, November 4, 1974. When viewed against these realities, the record does not support Equity Funding's convicted president Stanley Goldblum's testimony that without Dirks the fraud might have continued. See M. Comer, *supra*, at 205 ("Thieves, particularly if they have been successful for a long time, may become arrogant enough to believe they are too clever to get caught.").

[47] *Sykes* v. *Director of Public Prosecutions*, [1961] 3 W.L.R. 371, 384-85, 391; see Statute of Westminster First, 3 Edw., c.9 (1275); Statute of Westminster Second, 13 Edw., c.6 (1285); cf. 18 U.S.C. 4.

the officials charged with protecting the public interest.[48] More importantly in the context of this case, the common law forbade citizens from profiting by their secret knowledge of illegal conduct. As Lord Westbury stated in voiding a contract not to report a crime,

> [i]t is a law dictated by the soundest consideration of policy and morality, that you should not make a trade of felony. *If you are aware that a crime has been committed, you shall not convert that crime into a source of profit or benefit to yourself* * * *. If men were permitted to trade upon their knowledge of a crime, and to convert their privity to that crime into an occasion of advantage, no doubt a great legal offence and a great moral offence would be committed.[49]

Creating a special rule to allow insiders and tippees to profit from their knowledge of illegal corporate activity runs afoul of these principles and would more likely impede than guarantee prompt disclosure of crime to public officials. As Dirks himself conceded, "[t]he last thing a man with information on Wall Street wants to do is make that information public." *The Great Wall Street Scandal*, *supra* note 11, at 282. Information begins to lose value in the stock market as it begins to become public; the analyst's true incentive is to keep information secret,

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[48] *Roberts*, 445 U.S. at 558; *see Branzburg*, 408 U.S. at 697-08. This Court has forcefully rejected the notion that persons with information relevant to the commission of crime may be excepted from the requirement that they "plac[e] their trust" in public officials because they wish to make their knowledge public in another manner. *Branzburg*, 408 U.S. at 695.

[49] *Williams* v. *Bayley*, L.R. 1 H.L. 200, 220 (1866) (emphasis added). See also *Sykes* v. *Director of Public Prosecutions*, [1961] 3 W.L.R. 371, 383 (concealment and profit are essential elements in compounding a felony). Most states have adopted this policy in their criminal laws by prohibiting profiting from agreements not to report crime. Note, *Compounding Crimes: Time for Enforcement*, 27 Hast. L.J. 175, 187-88 (1975); see, e.g., Cal. Penal Code 153 (West 1970).

at least until his clients have had the opportunity to profit from it.[50] Indeed, the "soft story" that Dirks gave to those who did not own Equity Funding stock see supra n.13, suggests that he did not intent to disseminate the fraud information "as broadly as possible" (R. 460-62) and belies the notion that permitting trading on inside information about crime will promote detection of criminal conspiracies.[51]

Moreover, since neither Dirks nor the Solicitor General provides a workable standard as to when trading on information evidencing criminal conduct may take place, the exception they propose could well lead to uncertainties in the securities markets. As this Court has observed, in the corporate world what may appear initially to be criminal conduct may actually be within a broad " 'gray zone of socially acceptable and economically justifiable business conduct' " and thus entitled to confidentiality. *Upjohn Co.* v. *United States*, 449 U.S. 383, 392-93 (1981), quoting *United States* v. *United States Gypsum Co.*, 438 U.S. 422, 440 (1978). If Dirks and the Solicitor General are suggesting a theory permitting trading on inside information only about conduct that is later adjudicated to be criminal, such a rule would be perilous for both the ordinary investor and the securities professional prospectively to apply. Alternatively, to permit trading on the basis of any inside information that arguably suggests illegal conduct would open the markets to massive trading on inside information. Indeed, under the broad exception proposed by Dirks and the Solicitor General, tippees might be free to trade on information

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[50] See Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 Vand. L. Rev. 621, 623 (1970); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1448-49 (1967).

[51] Although Dirks states that neither he nor his firm traded in Equity Funding stock (Br. 16), nothing in the theory that he and the Solicitor General suggest would preclude persons in Dirks' position from trading on inside information about corporate crime. Indeed, their theory would encourage such persons so to trade.

about intentionally unreported bad news that does not rise to the level of criminal activity.[52]

Contrary to the contentions of Dirks (Br. 28-31) and the Solicitor General (Br. 28-29), the Commission's decision will not inhibit analysts' customary research or impair market efficiency.[53] Analysts remain free to obtain from corporate management corporate information that is not itself material for purposes of filling in the "interstices in analysis" and "testing the meaning of public information * * *" about corporate activities. *Investors Management Co.*, 44 S.E.C. at 646.[54] As the Commission reported to Congress in the *Institutional Investor Study, supra* p. 37, at 2539, the insider trading proscriptions do

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[52] Since willful failure to file required reports with the Commission (Section 13(a) of the Securities Exchange Act, 15 U.S.C. 78m), like any other willful violation of the Securities Exchange Act, is a crime (Section 32, 15 U.S.C. 78ff; cf. S.G. Br. 29), material facts that should have been disclosed in such reports but were not could be viewed as evidence of possible crime.

[53] See J. Lorie, *Public Policy for American Capital Markets* 3 (1974) (submitted to the Secretary of the Treasury) ("[T]he American capital markets * * * deserve high marks for efficiency both absolutely and relative to foreign markets") ["*Public Policy for American Capital Markets*"]. We do not question that the Solicitor General speaks authoritatively regarding the federal criminal law. But, Congress made the Commission responsible for ensuring that our securities markets are fair and efficient. See S. Rep. No. 792, 73d Cong., 2d Sess. 5 (1934); H.R. Rep. No. 1383, 94th Cong., 2d Sess. 7 (1934); see also H.R. Rep. No. 123, 94th Cong., 1st Sess. 92 (1975). In these circumstances, courts are not free to "disregard [an] agency's view" of one of its statutes and to construe the statute based on their "own view of what would best serve the purpose and policy" of the statute. *Federal Election Commission* v. *Democratic Senatorial Campaign Committee*, 454 U.S. 27, 36 (1981); see also *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965).

[54] Only a "small fraction" of the information analysts acquire in their dealings with corporate insiders falls into the category of "inside information." Inside Information Comm. of the Fin. Analysts Fed'n, *New Guidelines on Inside Information*, Fin. Analysts J., Jan./Feb. 1974 at 23 ["*Guidelines on Inside Information*"]; see also *NYSE Company Manual* A-21.

not preclude "the exercise of customary institutional information gathering functions—the process by which bits and pieces of corporate information are integrated and analyzed for investment decisionmaking purposes * * *." Professional securities analysts have themselves declared use of inside information an unethical professional practice.[55]

Further, analysts do not view themselves as private investigators of criminal activities.[56] In the rare case in which an analyst does obtain material inside information evidencing criminal conduct, his professional obligation is not to remain silent but to report the information to an exchange, this agency or other law enforcement authorities.[57]

The Commission's decision to encourage analysts to report crime to the proper authorities rather than to permit trading on the undisclosed information is thus entirely reasonable. As Professor Lorie observed, while "[p]ublic policy should not generally prohibit the private exploitation of private information, * * *"

> a reasonable policy would be to require that indications of illegal actions by a corporation be disclosed to the proper authorities—typically the SEC in cases

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[55] *Code of Ethics and Standards of Professional Conduct of the Financial Analysts Federation* (as amended May 9, 1982) ["Code of Ethics"]; *Guidelines on Inside Information* at 20-25. See generally W. Chatlos, *Financial Analysts' Handbook* 74 (Levine ed. 1975); *NYSE Company Manual* A-19; C. Reich, Com. & Fin. Chron., May 17, 1973, at 13.

[56] Contrary to Dirks' suggestion (Br. 30), analysts report that they "very infrequently" obtain inside information of illegal corporate practices. Guidelines on Inside Information at 24. As Dirks previously conceded, "[i]t is rare, indeed, when an analyst uncovers a case of out-right fraud." Dirks & Gross, *supra* n.11, at 287.

[57] *See Code of Ethics, supra* note 55, Standard IIC; *The Financial Analysts Federation 1981 Membership Directory* at 23; see also W. Chatlos, *Financial Analysts' Handbook* 85; *Guidelines on Inside Information* 24; *Wall Street Analysts Agree: Raymond Dirks Blew It*, Com. & Fin. Chron., April 19, 1973 at 11.

> involving securities—before the discoverer of the information is allowed to act upon it. A reasonable interval should intervene between the notification to the authorities and the action by the informer.

Public Policy for American Capital Markets at 11.[58] The authorities can investigate discreetly, without creating the market disruption and concomitant unfairness that occurs when sensational and unproved allegations are passed from one investor to another.[59]

This Court should firmly reject the novel proposal to give tippees of insiders "a financial reward" (Dirks Br. 31) in the form of permission to trade on secret knowledge that a crime has been committed. When Congress has decided to provide rewards to persons who inform authorities about violations of federal law, it has done so expressly by statute. See, e.g., 26 U.S.C. 7623; 26 C.F.R. 301.7623-1; 33 U.S.C. 411. Even when Congress has legislated rewards, it has authorized that they be paid from fines collected from the wrongdoers themselves or from the public treasury. In contrast, here the bounty would come from the pockets of innocent investors on whom selected shareholders with inside information dumped stock. Nothing in the present securities laws suggests that Congress intended this astonishing result.

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[58] The Commission agrees that the informant is free to trade so long as at the time of the trade the information has become public or is disclosed to the buyer.

[59] Surprisingly, the Solicitor General suggests (Br. 29-30) that permitting analysts and other outsiders to trade on secret information of criminal activities would promote fairness to investors and public confidence in the securities markets. While some large investors with access to analysts' reports might benefit by his theory, other investors would inevitably be its victims. Indeed, Professor Lorie has noted that individual investors attribute lack of confidence in the market to "a feeling that individuals are at a disadvantage compared with institutional investors because the latter receive preferential treatment from brokers * * *." *Public Policy for American Capital Markets* at 5. All of Dirks' tippees in this proceeding were large institutional investors.

III. SUBSTANTIAL EVIDENCE IN THE RECORD SUPPORTS THE COMMISSION'S FINDING THAT THE INFORMATION DIRKS SELECTIVELY DISSEMINATED WAS MATERIAL

Applying the materiality standard adopted by this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976), the Commission found that the information Dirks obtained from Secrist and other Equity Funding insiders would have been important to a reasonable investor (Pet. App. B14-19). The Commission found that the information Dirks obtained from Secrist on March 7 was itself material because it came from a former Equity Funding vice-president, was "specific" and "detailed," had "considerable objective indicia of reliability," and its significance to the market prices of Equity Funding securities was "immediately clear" *id. at* B14-15). Indeed, Boston made substantial sales based on this information alone (*id.*). The Commission found that by the critical March 23-26 period the information was "clearly" and "unquestionably" material (*id.* at B15).[60] By that time, the basic information about the fraud, and even arcane details, had been repeatedly corroborated by the Equity Funding insiders who Secrist had said would verify his story (*id.* at B14-15; J.A. 201, 202, 213, 234-36, 239-42, 257). The court of appeals held that these findings were supported by substantial evidence (Pet. App. C1-2), and that determination is conclusive absent extraordinary circumstances. See *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 491 (1951); cf. *Graver Tank & Mfg. Co.* v. *Linde Air Products Co.*, 336 U.S. 271, 275 (1949).[61]

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[60] The Commission found Dirks' conduct between March 23 and March 26 alone would justify the censure (Pet. App. B26 n.54).

[61] On review "[t]he findings of the Commission as to the facts, if supported by substantial evidence, are conclusive." Section 25(a)(4) of the Securities Exchange Act, 15 U.S.C. 78y(a)(4). See *Steadman* v. *SEC*, 450 U.S. 91, 96 (1981); *Consolo* v. *Federal Maritime Commission*, 383 U.S. 607, 620 (1966).

Dirks' argument that the information at issue here was so unreliable that it was not material rests upon an attempt in this Court to relitigate for the fourth time factual contentions that were rejected by the administrative law judge (J.A. 250-74, 299-300), the Commission (Pet. App. B14-17), and the court of appeals (*id* at C1-2; *id* at A31-35).[62] Each dismissed Dirks' contention (Br. 36-37) that much of the detail of Secrist's information was "wrong" and "only three" of "the eight allegations regarding Equity Funding made by Secrist" turned out to be true (J.A. 253 n.42, 260; Pet. App. B14-15; A8, A34 & n.24). Both the administrative law judge and the court of appeals expressly stated that the "basic allegations" of insurance fraud were true, and that Dirks believed that they were probably true. (J.A. 253 n.42; Pet. App. A34 n.24; see also R. 10,772-80).[63]

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[62] There is no merit to the suggestion in Dirks' brief (Br. 35) that inside information is not material unless it has been proved to be true when the trading takes place. The possibility that an event will occur can be "a most material fact affecting the value of" a company's shares. *Strong* v. *Repide*, 213 U.S. at 432. Just as corporate officials do not await positive proof before purchasing options on property they believe to contain a remarkable ore deposit, see *Texas Gulf Sulphur*, 401 F.2d at 839-40, 843-44, 852-55, reasonable investors do not await certain proof that a company has fraudulently overstated its assets before liquidating their holdings. Moreover, in the cases relied upon by Dirks (Br. 35) the courts did not hold that information must be proved true before it becomes material. Rather, they determined, based on the particular facts before them, that the omitted information would not have been important to a reasonable investor because of the speculative or tenuous nature of the information. See, e.g., *Hassig* v. *Pearson*, 565 F.2d 644, 649 (10th Cir. 1977).

[63] Dirks arbitrarily divides the substance of his three-and-one-half hour conversation with Secrist into "eight allegations" and then claims that only three "turned out to be true" (Br. 37; see also 7-8). Secrist's report could be divided in innumerable ways. The administrative law judge divided Secrist's disclosures into

Nor was Secrist an incredible witness, as is demonstrated by the swift action of the insurance regulators upon hearing his story.[64] Likewise the Commission and the court of appeals expressly rejected Dirks' contention (Br. 35) that the information he obtained was merely "rumor" (Pet. App. B15, A35; see also J.A. 256).[65] Finally, the other insiders who corroborated Secrist's report were found to have supplied not "rumors" (Br.

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31 detailed areas (J.A. 192-94), most of which turned out to be true (J.A. 253 n.42). Moreover, Dirks provides no citation to the record for the proposition that the five purported false allegations, which are in any event insignificant, were ultimately proved incorrect. Most were in fact not proved to be false. For example, contrary to Dirks' contention (Br. 7-8), Secrist's report about insider sales was substantiated by the trustee's investigation which revealed that top Equity Funding officials had "realized huge profits" by selling Equity Funding securities prior to the disclosure of the fraud (R. 10,811, 10,814). In addition, Secrist did not, as Dirks suggests (Br. 8, 36-37), state that he was certain Equity Funding was selling limited partnerships in phony real estate; he represented this as a mere possibility, not as a fact (R. 245-47).

[64] Dirks suggests (Br. 35-38) that Secrist was not credible because Secrist was allegedly a disgruntled employee. As the administrative law judge observed (J.A. 256-57), however, a former corporate vice-president like Secrist is not likely to risk industry-wide scorn by spreading false reports of crime about his former employer. Furthermore, Dirks himself found Secrist to be credible, unbiased, straight-forward, and solid; and he believed that Secrist's information "held together well under questioning by two insurance analysts" (R. 1642, 1644).

[65] Both the Commission (Pet. App. B15 n.30) and the court of appeals (*id.* at A35) rejected Dirks' contention that the information he had was comparable to the rumors about Equity Funding that were at issue in *Pachter* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 444 F. Supp. 417, 422 (E.D.N.Y.), aff'd mem., 594 F.2d 852 (2d Cir. 1978), and *Weiner* v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764 at 95,001 (S.D.N.Y. 1979). "Rumors" are "[u]nverified information of uncertain origin." *American Heritage Dictionary of the English Language* 1135 (1969). Dirks and his tippees were well aware of their sources.

36) but rather in many cases first-hand evidence of the fraud (J.A. 234-40; Pet. App. B6-9, B17; A34).[66]

Dirks also attempts to reargue (Br. 38-42) his contention that the reactions of certain nonselling investors and regulatory officials confirm that the story was unbelievable.[67] As the administrative law judge found, Dirks never demonstrated that the non-selling investors either heard the same information as he did or stood in the posture of a reasonable investor (J.A. 267-74).[68] Nor did

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[66] Dirks misstates the record in asserting that Secrist characterized the persons who might corroborate his story as " 'wild, and erratic, and given to elaborate fantasies' " (Br. 37 n.23). Secrist's reference to "wild and erratic" persons was directed to the officers who carried out the fraud, not to the persons who were to corroborate Secrist's report (R. 711). There is also no basis in the record for Dirks' unsupported assertion (Br. 37) that Secrist told Dirks that Stanley Goldblum was not involved in the fraud. Indeed, Secrist told Dirks that Goldblum thought like a crook (R. 546) and that "most" of the top Equity Funding officers were involved (R. 481).

[67] Dirks suggests (Br. 37-38) that even by the end of his investigation all he had obtained was an "inherently unbelievable" story. But the administrative law judge found that Dirks himself believed that the disclosures were probably true (J.A. 258-60, 265; see also Pet. App. A34 & n.24) and that his contrary testimony "was less than candid" (J.A. 299-300).

[68] Dirks names (Br. 39) only four non-selling investors but suggests that "many other members of the investment community who heard some or all" of the allegations rejected them (Br. 39 and n.25 citing his brief in the court of appeals. As for the investors that Dirks mentions in his brief to this Court, two (Gene Mercy and Laurence Tisch) were found by the administrative law judge to be atypical because of their close personal relationships to Equity Funding management (J.A. 274); with respect to the other two, the administrative law judge found the evidence insufficient to find why they did not sell (J.A. 273 n.51).

Of the investors referred to in Dirks' court of appeals' brief, four of those are already mentioned. As for the others—none of whom were tipped by Dirks—the administrative law judge found that there was "lack of satisfactory proof" that they had received information of the detail and specificity as that received by Dirks' tippees (J.A. 273). One of the persons, Saul Cohen, reported what he heard to the NYSE and urged it to begin an investigation (R. 9058-61, 9234-36).

he show that the government agencies considered the allegations to be unbelievable. Accordingly, the Commission's finding of materiality, involving "delicate assessments" which are "peculiarly ones for the trier of fact," should be affirmed. *TSC* v. *Northway, Inc.*, 426 U.S. at 450.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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I authorize the filing of this brief. But see Brief for the United States as Amicus Curiae in Support of Reversal, filed December 30, 1982.

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